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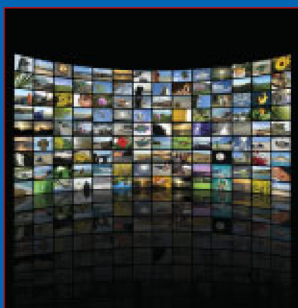

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Middle and Back Office Outsourcing – The Time is Now

Many experts in the financial world predict the death of the hedge fund industry. Yannis Matsis of Point Nine expects the industry to consolidate and restructure to a new business model that will be more robust and long lasting and will ultimately allow the industry to grow and flourish again. Let's look at the facts.

Fact 1: The Growth and Subsequent Marginal Decline of the Hedge Fund Industry

During the period 2005-7, hedge funds generated average annual total returns of 10.63% net of fees *(source: Greenwich Global Hedge Fund Index)*. This positive performance, in combination with net investor inflows (subscriptions), saw the Assets Under Management of the hedge fund industry steadily grow from $1 trillion in Jan 2005 to a peak $1.8 trillion in December 2007.

During 2008, hedge funds are generating Year-To-Date returns of -14.3% *(source: Greenwich Global Hedge Fund Index)*. This poor performance, coupled with significant investor outflows (redemptions) at the later part of 2008, saw the hedge fund industry experiencing its first ever decline in AUM, from $1.8 trillion in December 2007 to $1.65 trillion in Oct 2008.

Fact 2: Hedge Fund Industry Fee Structure

The standard annual fee structure that hedge fund managers charge their investors is 2% management fee on the AUM and a 20% performance fee levied on any positive returns generated by the hedge fund manager.

As a result of the positive performances experienced during 2005-7, hedge funds generated average annual fees of 4.66% of AUM, or in absolute dollar terms, $65.2 billion. For 2008, the average performance fee will be 0%, and hedge funds will generate only the management fee of 2%, or in absolute dollar terms, $34.5 billion.

For the average hedge fund manager, the fee earned in 2008 will be 53% of the fee that was earned on average during the last 3 years, and 43% of the fee that was earned last year.

Fact 3: The Closure of Hedge Funds

A fundamental shake up of the industry is already happening, forcing at least the weakest of managers out of the industry. Those of the hedge funds that are facing the biggest losses and/or redemptions are already closing down. A number of others are citing market disruption events which allows them to suspend further redemptions until the situation calms down.

Brave New World

These are the facts. It is the conclusion that one draws from them that is important. So, as some financial experts see this in a negative manner, we see matters from another point of view. That view shows promise for the future.

Common consensus is for investor outflows to continue at a fast pace and for the size of the industry to reduce by anything between 20%-50%. We also think that the industry will shrink, but only for the short term.

Furthermore, we believe that investors will demand a change in the fee structure. We expect that the standard management fee of 2% will decrease on average, and also vary depending on the specific strategy of the managers. The performance fee is also expected to decrease, and to be earned at the end of the lock-in periods, or upon investor redemption, instead of the current annual charge. These changes will both reduce the absolute fee for hedge fund managers and also push it further out in time.

We believe that the new model, along with the managers that will be left to support it, will be more robust and long lasting and will ultimately allow the industry to grow and flourish again.

One immediate response by hedge fund managers to the current and expected further drop in fees will be to manage their cost base tightly. This will not only secure the short term survival of the manager, but will also ensure that a robust long term business model is built, which relies not only on fee growth through successful performances and accumulation of AUM but also on cost reduction.

Industry surveys indicate that the most significant cost for hedge fund managers are the salaries and discretionary or performance-driven formulaic bonus of the front office

trading/portfolio management team. The second significant element of a hedge fund's cost base is the middle and back office operation costs, which are between 35%-50% of the management fee, or in other words between 0.7%-1% of the AUM, or in absolute dollar terms, between $11.6 billion and $16.5 billion across the whole industry, assuming current AUM of $1.65 trillion. Other less relevant costs are marketing and public relations.

The biggest issue with cutting costs is that, one way or another, it eventually permeates through the institution and adversely affects the quality of product that is produced. In the case of a fund manager, this is investor returns through excess performance (otherwise known in the industry as “alpha”). For example, it is very likely that the investor returns will be reduced if the quality of either the trading/portfolio management team or the risk management team deteriorates due to the cost cutting exercise. Hence the biggest cost of a hedge fund is also very difficult to reduce.

The Case for Middle and Back Office Outsourcing

A different case can be made with certain functions of a fund manager's middle and back office operations area. There is not much subjectivity involved in carrying out most of these middle and back office operation functions. The job can either be done correctly, or not. A transaction will either be correctly captured by the systems and securely stored in the database, or it will not. A payment will either be made or received as expected, or it will not. A position report will either contain all the information expected by the trader/portfolio manager, or it will not. The rate with which transactions fail to be captured, processed and reported in the expected way can be measured objectively (otherwise known in the industry as the “break rate”).

Due to their repetitive and objective nature, middle and back office operations can, and do, rely largely on systems and some manual oversight to successfully perform their task. This means that they can offer significant economies of scale. An operations team that has the ability to process all transactions executed by a fund manager at a very low break rate should be able to process an equal volume of similar transactions of another fund manager at the same break rate without doubling its costs.

Put simply, one system, one IT team, one disaster recovery process and one set of experienced middle and back office professionals is just much more efficient than two sets of each.

Middle and back office operations can therefore be ideal for outsourcing and at the same time cutting costs without sacrificing the quality of service or increasing a fund manager’s operational risk. Operations can be centralised around skilled experienced professionals and specialised systems built by experts specifically for middle and back office operations. The result is a better service than can be provided by an internal team and lower operational risk.

We believe that it is not only inevitable, but also the correct approach, for fund managers to reduce their costs through outsourcing some of their middle and back office operations. Industry surveys already indicate that in excess of 25% of hedge fund managers are looking to outsource some or all of their operations.

We believe that the first wave of outsourcing will be in reconciliation of transactions, settlement of cashflows and assets and life cycle event processing (e.g., fixings, corporate actions, etc.). This will be followed by transaction capturing and storing for books and records purposes, generation of reports (e.g., position reports, cashflow and liquidity reports, option exercise schedules, etc.) and collateral management. At the same time, some fund managers, especially start-ups, will choose to outsource immediately all of their middle and back office operations.

In doing so, fund managers should be careful. The obvious risk of such an exercise is to outsource to a service provider that cannot deliver a service that is at least as successful and efficient as the internal operations team, and that cannot offer a reduction in operational risks. Such a mistake can of-course be reversed, but at a significant monetary, time and morale cost, which will defeat the whole exercise to begin with.

The hidden risk is to outsource to a provider whose service deteriorates for whatever reason, or even completely closes down, at some point in the distant future, when the fund manager is completely reliant on the external service. In such a case, fund managers may experience serious disruption events, possibly even a loss of their data. For this reason, fund managers that choose to outsource should:

- carry out extensive due diligence of the company that will provide the service, including its systems and operations,
- ensure a service level agreement that safeguards the fund manager's interests,
- understand the format and structure that their data will be stored in,
- ensure immediate and free access to that data,
- have plans on how to immediately migrate and use such information in such a scenario.

A complete middle and back office outsourcing solution should have the ability to capture and process the majority of capital market financial instruments, from equities to complex derivative products. An outsourcing service provider should rely on state-of-the-art technology and be staffed with experienced, professional and energetic personnel that will form a natural extension of a fund manager's existing operations. The outsourcing service provider should ensure a robust and secure operation that will offer a seamless and continuous service to its fund manager clients and build with them long lasting relationships.

Point Nine

Point Nine offers middle and back office services to Financial Institutions. Our operations team, in combination with our proprietary developed web-based operations platform, help our clients to complement their existing middle and back office operations or even become their complete one-stop middle and back office solution.

Point Nine’s services include Trade Capturing and Management, Trade Processing and Operations and Reporting. We have the ability to capture and process the majority of capital market financial instruments, from equities to complex OTC derivative products. Point Nine’s technology interfaces with a number of prime brokers and fund administrators and provides accurate and secure transactions, which are processed by experienced staff across three locations in Europe, Asia and the Middle East.

Point Nine’s client base includes large traditional Asset Managers, pioneering Hedge Funds and tier-1 Banks.

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